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PROTOCOL TO CHINA TAX TREATY

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Mr. LUGAR, from the Committee on Foreign Relations, submitted the following

REPORT

[To accompany Treaty Doc. 99-26]

The Committee on Foreign Relations, to which was referred the protocol, signed at Beijing on May 10, 1986, concerning the interpretation of paragraph 7 of the protocol to the agreement between the Government of the United States of America and the Government of the People's Republic of China for the avoidance of double taxation and the prevention of tax evasion with respect to taxes on income, signed at Beijing on April 30, 1984, having considered the same, reports favorably thereon without amendment and recommends that the Senate give its advice and consent to ratification thereof.

PURPOSE

The Protocol amends the China tax treaty (Treaty Doc. 98-30) to insure that only bona fide residents of the contracting states may benefit from the treaty's provisions.

SUMMARY

The Department of the Treasury has provided the following technical explanation of the protocol:

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TREASURY DEPARTMENT TECHNICAL EXPLANATION OF THE PROTOCOL SIGNED AT BEIJING ON MAY 10, 1986 CONCERNING THE INTERPRETATION OF PARAGRAPH 7 OF THE PROTOCOL TO THE AGREEMENT BETWEEN THE GOVERNMENT OF THE UNITED STATES OF AMERICA AND THE GOVERNMENT OF THE PEOPLE'S REPUBLIC OF CHINA FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF TAX EVASION WITH RESPECT TO TAXES ON INCOME, SIGNED AT BEIJING ON APRIL 30, 1984

The Protocol signed at Beijing on May 10, 1986 (hereafter referred to as "the Protocol") amends the Agreement and accompanying Protocol and Exchange of Letters which were signed at Beijing on April 30, 1984 (hereafter referred to as "the Agreement"). The Protocol contains only one article, which limits the benefits of the Agreement to bona fide residents of the Contracting States. It is intended to prevent residents of third countries from inappropriately using a company which is a resident of one of the Contracting States as a conduit or similar vehicle to obtain tax benefits provided by the Agreement.

The Protocol provides that a person (other than an individual) which is a resident of one of the Contracting States is entitled to relief from taxation by the other Contracting State only under certain conditions. Paragraph 1 provides two alternative conditions of eligibility for benefits under the Agreement. The first condition involves two parts, both objective tests relating to the person deriving the income. The first test is that more than 50 percent of the beneficial interest in such person (or in the case of a company, more than 50 percent of the number of shares of each class of the company's shares) must be owned, directly or indirectly, by any combination of: individuals who are residents of the Contracting States, citizens of the United States, the Contracting States themselves or political subdivisions thereof, or publicly traded companies which are residents of one of the Contracting States. In addition, in the case of reduced taxation at source of dividends, interest, or royalties, not more than 50 percent of the gross income of such person may be used, directly or indirectly, to pay interest to persons other than those enumerated in the ownership test. These ownership and "base erosion" tests are intended to serve as safe harbors for persons which can establish satisfaction of such mechanical tests.

The second condition, which is an alternative to the first two-part condition described above, is met if the person deriving the income is a company which is a resident of a Contracting State and its principal class of shares is the subject of regular and substantial trading on a recognized stock exchange, as defined in paragraph 3. A publicly traded company that is a resident of the United States or the People's Republic of China is considered to have a suf-

ficient nexus with that country, respectively, to entitle it to the benefits of the Agreement.

Paragraph 2 provides a third alternative, under which the benefits of the Agreement are available to a person if the establishment, acquisition and maintenance of the person and the conduct of its operations did not have as a principal purpose the purpose of obtaining the benefits of the Agreement. This condition recognizes that persons resident in third countries may own an entity that is a resident of the United States or China for valid business reasons, and that granting benefits to such an entity may be consistent with the goals of the Agreement. This condition would be met, for example, if a Chinese company owned by third country residents conducts business operations in China and its U.S. investments are related or incidental to those business activities, or if the aggregate tax burden in China equals or exceeds the tax reduction claimed under the Agreement. It could also be met in other situations.

Paragraph 3 defines a "recognized stock exchange" for the purposes of paragraph 1(b). A recognized stock exchange means U.S. registered stock exchanges, the NASDAQ system in the United States, any national securities exchange approved and established by the People's Republic of China, and any other stock exchange agreed upon by the competent authorities.

Paragraph 4 provides that the competent authorities shall consult each other before benefits are denied under this Article. This consultation obligation is intended to benefit the governments of the two Contracting States. The denial of benefits requires consultation, but is not dependent on the prior agreement of the competent authorities.

The Protocol is an integral part of the Agreement. Thus, its entry into force and duration are covered by Articles 27 and 28, respectively, of the Agreement.

Committee Action

The Committee approved the Protocol by a vote of 16–0 at its June 12, 1986 business meeting. Voting in the affirmative were Senators Lugar, Mathias, Kassebaum, Boschwitz, Pressler, Murkowski, Trible, Evans, Pell, Biden, Sarbanes, Zorinsky, Cranston, Dodd, Eagleton and Kerry.

Committee Comments

As Senator Lugar indicated at the business meeting, the Protocol will be considered together with the treaty on the Senate floor. The resolution of ratification to this Protocol incorporates the China tax treaty and a supplementary protocol submitted with the treaty. Accordingly, approval of this resolution by the Senate will result in Senate consent to the treaty, the supplementary protocol that accompanied the treaty and this protocol.

Resolved (two-thirds of the Senators present concurring therein), That the Senate advise and consent to the ratification of the Agreement between the Government of the United States of America and the Government of the People's Republic of China for the Avoidance of Double Taxation and the Prevention of Tax Evasion with Respect to Taxes on Income, together with a supplementary protocol and exchange of notes, signed at Beijing on April 30, 1984, and a protocol concerning the interpretation of paragraph 7 of the supplementary protocol, signed at Beijing on May 10, 1986.

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